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We Are Not Publicly Traded And So The Rules Don't Apply... Or Do They... Should They?

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ABSTRACT

This paper presents a case study of the accounting practices of a company that is privately held. The company "follows" Generally Accepted Accounting Principles (GAAP) but has some questionable transactions. The paper then follows up with a discussion of baby-GAAP and possible consequences of two different GAAP options.

Keywords: GAAP; Small-GAAP; Large-GAAP; Baby-GAAP

INTRODUCTION

There has been a lot of discussion about "baby-GAAP" or "small-GAAP" for companies that are not publicly traded. The belief is that privately held companies have a difficult time complying with all of the GAAP rules in place and it places an undue burden on the companies. "Small businesses have complained for years that the financial reporting standards used in this country, which were developed and refined with large, publicly held corporations in mind, are too complicated for small, private companies. The accounting profession is starting to agree." This quote was taken from an article written in 1982 by Harvey Moskowitz. Fast-forward almost 30 years, the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Foundation (FAF) and the National Association of State Boards of Accountancy (NASBA) formed a blue ribbon panel to address how accounting standards can best meet the needs of private company financial statement users. The result of this panel was that there are "urgent and growing systemic issues that need to be addressed in the current system of the United States accounting standard setting" (Blue-Ribbon Panel on Standard Setting for Private Companies (2011)).

The United States does not have a statutory requirement for private companies, other than regulated companies, to prepare financial statements using GAAP (Blue-Ribbon Panel on Standard Setting for Private Companies (2011)). These companies can choose to prepare financial statements using U.S. GAAP or Other Comprehensive Basis of Accounting (Blue-Ribbon Panel on Standard Setting for Private Companies (2011)). However, if a company states that it prepares financial statements using U.S. GAAP, then users of the financial statements have certain expectations that these financial statements should meet.

The following is a case study about a small privately owned organization that is comprised of three companies. This company overall portrays that it follows GAAP. However, in some instances the company simply does what best suits the company and derails in following GAAP. Following the case study is a discussion of the advantages and disadvantages of baby-GAAP and how such changes would affect this company. Following the discussion is the conclusion of the paper.

ORGANIZATION OF THE COMPANY

Candles Incorporated manufactures and sells candles¹. Therefore the company has the typical inventory, administrative, buying, manufacturing and sales expenses. Sara Jones is the sole owner of Candles Incorporated. Bart Green is the Controller for Candles Incorporated. Since his employment with Candles Incorporated Bart has been very suspicious of some of the financial reporting activities of the company. For the reason that Candles Incorporated is privately held it is not required to follow GAAP, but should follow some standard when preparing financial statements. However, the creditors of the company are led to believe that the statements are prepared in accordance with GAAP. This implies that the creditors can rely on the financial statements prepared by Candles Incorporated and compare them to similar companies in the industry. Candles Incorporated is comprised of the main company, the selling company and the rental company. Candles Incorporated has an outside auditor that examines the financial statements to determine if the statements are prepared in conformance with GAAP. The main purpose of the outside accountant is to provide assurance to the bank that the company is solid and the financial statements are a fair representation of the financial position of the company. The problem is that since the outside accountant does not actually perform an audit, Candles Incorporated is not held to the high standards that the creditors are accustomed to when an outside accountant provides any kind of assurance documentation.

The company owes a considerable amount of money to the bank, more than ½ of its assets. It is important to the bank that the company meets its obligation to the bank. Due to the strained performance of Candles Incorporated in the past the bank has implemented loan restrictions. These debt covenants include not allowing the owner to take any distribution of the earnings. This company is in a position to engage in “creative” accounting in order to allow the owner to withdraw money and still comply with the bank stipulations.

MAIN COMPANY

The main company is organized as a C-corporation. The main company reports all of the inventory and the business activities. When a sale is made inventory is transferred to Candles Sales Incorporated and the actual sale is reported in the Candles Sales Company.

SELLING COMPANY

Candles Selling is organized as an S-Corporation. Candles Selling uses the cash basis method to account for its financial activities. One thing about this company that has always bothered Bart is that the company reports accounts receivables on the balance sheet. Another interesting point is that Candle Selling has no allowance for doubtful accounts reported with the accounts receivable account. It is questionable as to whether or not an allowance account is necessary. The presence of accounts receivable says yes, but the fact that is it a cash company implies that the allowance is not necessary. However, experience has shown Bart that an allowance account is necessary because he has had to write off a few large accounts over the years. Candle Selling is organized as a cash company and reports all of the sales of inventory for the company.

RENTAL COMPANY

The Rental Company is organized as an S-Corporation. The only purpose of this company is to hold the building and property Candles Incorporated owns. Candles Incorporated owns a building that houses the administrative employees, the warehouse that houses the inventory and the building that serves as the manufacturing plant.

The Candles Incorporated pays the Rental Company rent for the use of the assets. The rental agreement is based on a month-to-month basis and the arrangement gives Candles Incorporated the flexibility to “move”/shift income and expense. If the main company needs to appear to be more profitable Bart simply reduces the rent paid to the Rental Company. If Candles Incorporated needs to appear less profitable (typically for tax purposes) Bart

¹ This information was obtained from the controller from an actual privately held company. The controller allowed use of the information with the agreement that the name of the company would not be disclosed.

increases the rent paid to the Rental Company. Typically these adjustments are made as necessary on an annual basis.

BABY-GAAP

Financial statements are prepared with the assumption that the users of the financial reports understand the conventions of accounting principles that are applied Hall (2008). The Blue Ribbon Panel (2011) reported that the current accounting system has not done a very good job of understanding what information is useful in the decision making process for the users of the private company financial statements. Further, they believe that there is a need to recognize that the outside user information needs are different between users of publicly held companies and privately held companies. Moskowitz (1982) states “creditors, including lenders and suppliers, are the primary users of private-company financial statements...Standards designed primarily to meet needs of outside investors should not be applied to private companies.” The creditors for Candles Incorporated assume that the financial statements they are assessing are prepared in accordance with GAAP. Since the company is not publicly traded and does not report to the SEC they have very “creative” accounting. Candles Incorporated does have an outside accountant. The outside accountant provides an assurance letter that Candles Incorporated has prepared its financial statements in conformance with GAAP. In many cases private companies are not actually following GAAP. In some instances, GAAP may not be appropriate.

The Blue-Ribbon Panel believes that, for now, the system should focus on making exceptions and modifications to U.S. GAAP for private companies that better respond to the needs of the private company sector rather than move toward a separate, self-contained GAAP for private companies or a wholesale reorganization of GAAP (Blue-Ribbon Panel on Standard Setting for Private Companies (2011)). This may actually cause more confusion. The first thing that companies will do is try to figure out which accounting rules better suit them and try to “fit” under these rules. This is concerning because it could shift the movement to be publicly traded and vice versa. According to Melancon (2011), companies will have a choice on which GAAP they want to follow. Therefore if a company expects to go public they would choose to use the current GAAP rules. This is interesting because the situation could arise in which a company goes back and forth the between baby-GAAP and current GAAP. This would offer one more opportunity for companies to report under the system which best benefits the companies’ goals at the time of reporting.

According to Pacter (2008) the International Accounting Standards Board (IASB) is working on separate International Financial Reporting Standards for Private Entities. This is yet another choice companies would be faced with in making the decision of what accounting standards to use to prepare their financial statements.

PROS AND CONS

In the case of a small private company, it is often a burden to follow all the rules required by U.S. GAAP. As in the example of Candles Incorporated, often times private companies will apply accounting standards in a way that is the most beneficial to the company. Many believe that no real harm is done because there are no outside shareholders that lose. However, creditors could potentially be harmed in cases where the creditors do not understand that the company is not reporting its financial activities in a manner that is consistent with the creditors’ expectations. Suppliers that extend credit could also be adversely affected.

GOING PUBLIC

One of the biggest concerns of allowing a private company to follow a different set of GAAP rules is that if that company reaches the point it wants to go public, the accounting systems will have to be completely reworked. Or as mentioned previously, companies that are not publicly traded could switch between baby-GAAP and current GAAP and cause great confusion for the financial information users.

The move to International Financial Reporting Standards could be another concern with implementing baby-GAAP. Baby-GAAP would be yet another set of rules that accountants and auditors would have to know. Granted when the United States moves to IFRS, large-GAAP as we know it today should longer exist.

CONCLUSION

Candles Incorporated is an example of a privately held company that already applies accounting standards in a manner that does not always conform to U.S. GAAP. Creating a GAAP that exempts privately held companies from all of the large-GAAP standards could potentially cause more harm than good. Private companies need guidance when preparing financial statements. To ensure that the information provided by financial statements is pertinent to the users of the statements it is imperative that the users understand the standards used in the preparation of the statements. A dicey situation is created when a company misleads the users of the financial statements by allowing the users to believe the financial statements were prepared using U.S. GAAP when, in fact, they were not. This misrepresentation could not only misleads the user of the financial statements, but could also jeopardize the company's relationship with creditors and suppliers

AUTHOR INFORMATION

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